Case Comments

United States v. General Dynamics: The Deduction of Estimated Liabilities by Accrual Method Taxpayers: The All Events Test and Economic Performance

I. Introduction

Due to the effect of inflation and interest rates, taxpayers have long considered the time value of money in planning their tax affairs. This planning has resulted from the desire of the taxpayer to defer income for as long as possible while taking deductions as soon as the Internal Revenue Code (Code) allows.[1] Among the many issues relevant to such tax planning is the timing of deductions by an accrual method taxpayer. This issue is one that has been given specific treatment by Congress in recent amendments to the federal tax laws.[2] The timing of deductions is also a subject that has been given specific, although not always consistent, treatment by the Supreme Court in recent years.[3] The Supreme Court's most recent decision is the subject of this Case Comment.

In April 1987 the Court decided *United States v. General Dynamics Corp.*[4] The case dealt with the attempted deduction, by an accrual method taxpayer, of estimated liabilities for health care services which had been provided to the taxpayer's employees. The decision, explained in depth in Part V of this Comment, is important both for its interpretation of the Code[5] and for its treatment of other judicial decisions concerning the timing of deductions.[6] Especially important is the effect that *General Dynamics* will have on the 1984 amendments to the Code.[7]

This Comment will analyze the *General Dynamics* decision and predict its future effect on several areas of tax law. The Comment will begin by providing a brief explanation of the accrual method of tax accounting. It will then describe the all events test for the determination of when a deduction for a future liability may be taken by a taxpayer. Next, the recent congressional addition of an "economic performance" requirement to the all events test will be discussed.

After exploring this background information, the *General Dynamics* decision itself will be explained and analyzed. *General Dynamics* will be compared to the Supreme Court's decision in *United States v. Hughes Properties, Inc.*,[8] a 1986 case dealing with similar subject matter. Finally, this Comment will consider the future impact of *General Dynamics* upon the all events test and the economic performance requirement.

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1. For an illustration of the effect of the time value of money and deferral of deductions, see Note, *Salvaging Accrual Method Deductions: Adding a "Time Value of Money" Component to the "All Events" Test*, 40 Tax Law. 185, 188–90 (1986).

2. Particularly important was the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984) [hereinafter 1984 Act]. The relevant sections of the 1984 Act will be discussed in detail in Part IV of this Comment.

3. *See infra* notes 59–115 and accompanying text.

4. 481 U.S. 239 (1987).

5. *See infra* notes 79–93 and accompanying text.

6. *See infra* notes 116–24 and accompanying text.

7. *See* 1984 Act, Pub. L. No. 98–369, §§ 91, 98, 98 Stat. 494, 598–601 (1984) (codified as amended at I.R.C. § 461 (Supp. IV 1986)).

8. 476 U.S. 593 (1986).

II. Future Liabilities and the Accrual Method Taxpayer

Although the Code permits the computation of taxable income under several different methods,[9] a taxpayer will generally use one of two methods to perform this task.

The first method is the "cash receipts and disbursements method" (cash method). The cash method provides for the inclusion of income when the items that constitute that income (e.g. cash, property, or services) are actually or constructively received by the taxpayer.[10] Deductions by a cash method taxpayer are allowable when payment is actually made.[11] The cash method is used by most individuals and by many small businesses.[12]

The second method used for computing taxable income, and the method with which this Comment is concerned, is the accrual method. A concise explanation of the accrual method is provided in the Treasury Regulations:

> [U]nder an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy.[13]

Obviously, under such an approach, deductions will often be taken for expenditures that will not actually be paid out until some future date.[14] The *General Dynamics* case involved a specific factual situation where such a premature deduction was attempted by an accrual method taxpayer.[15]

Generally, C-corporations, as well as other businesses which keep some type of inventory, will use an accrual method to compute taxable income.[16] As indicated by the Treasury Regulation excerpted above,[17] the actual determination of when accrual method deductions may be taken will depend on the interpretation given to when "all the events have occurred which establish the fact of the liability,"[18] the so-called all events test.

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9. *See* I.R.C. § 446 (1982), which provides the general rules for determining which methods may be used. *See also* Treas. Reg. § 1.446-1 (1987).

10. Treas. Reg. § 1.446-1(c)(1)(i) (1987).

11. *Id.*

12. I.R.C. § 448 (1982 & Supp. IV 1986) provides the limitations on the use of the cash method of tax accounting.

13. Treas. Reg. § 1.446-1(c)(1)(ii) (1987).

14. For a more in-depth discussion of both the cash and accrual methods of tax accounting, see B. Bittker, Fundamentals of Federal Income Taxation § 35 (1983).

15. The facts of *General Dynamics* will be discussed in depth in Part V. *See infra* notes 63–78 and accompanying text.

16. I.R.C. § 448 (1982 & Supp. IV 1986) provides limits on the use of the cash method by a taxpayer. Treas. Reg. § 1.446-1(c)(2)(i) (1987) states that in any case in which an inventory is necessary, the accrual method must be used with regard to purchases and sales.

17. *See supra* note 13 and accompanying text.

18. *Id.*

III. The All Events Test

As discussed above, the ability of a taxpayer to take a deduction for an amount which has not actually been paid out is dependent upon the taxpayer meeting the requirements of the all events test. The test itself was first articulated in the 1926 Supreme Court case of *United States v. Anderson.*[19] The taxpayer in *Anderson* was a seller of munitions and was subject to an income tax on all of its profits.[20] Although the tax involved in *Anderson* was imposed on profits from the taxpayer's operations in the year 1916, the tax would not actually become due and payable until 1917. The Court, however, held that the taxpayer was required to take the deduction for the 1916 profit taxes in computing its 1916 taxable income.[21] In so holding, the Court stated:

> Only a word need be said with reference to the contention that the tax upon munitions manufactured and sold in 1916 did not accrue until 1917. In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books.[22]

The all events test was formalized in the Treasury Regulations in 1957,[23] but was not explicitly codified until the Deficit Reduction Act of 1984 (1984 Act).[24] The test has two prongs. The first prong, and the portion with which the *General Dynamics* decision was primarily concerned,[25] requires that liability for the deducted amount be firmly established before the deduction can be taken.[26] The second prong requires that the amount of the deduction be determinable with reasonable accuracy.[27]

The liability prong of the test has received a great deal of judicial consideration since it was first announced in *Anderson.*[28] The Court has interpreted the liability prong to disallow deductions when a liability is contingent[29] or when a liability is based upon events which have not occurred by the close of the taxable year.[30] In addition, deductions are not allowed in certain situations where the taxpayer's liability for the expense is contested.[31]

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19. 269 U.S. 422 (1926).

20. *Id.* at 435.

21. *Id.* at 442. Although a taxpayer will usually benefit by taking deductions as *soon* as possible, apparently the taxpayer in *Anderson*, for reasons which are unclear from the opinion, reduced his tax burden by deferring the deduction until 1917.

22. *Id.* at 440–41.

23. Treas. Reg. § 1.461-1(a)(2) (1987); Treas. Reg. § 1.446-1(c)(1)(ii) (1987).

24. *See* I.R.C. § 461(h)(4) (Supp. IV 1986).

25. *See infra* notes 79–93 and accompanying text.

26. Treas. Reg. § 1.461-1(a)(2) (1987).

27. *Id.*

28. United States v. Anderson, 269 U.S. 422, 440–41 (1926).

29. *See, e.g.*, Lucas v. American Code Co., 280 U.S. 445 (1930).

30. *See, e.g.*, Brown v. Helvering, 291 U.S. 193 (1934). *Cf.* American Auto. Ass'n v. United States, 367 U.S. 687 (1961).

31. *See, e.g.*, Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944).

However, deductions will, in many cases, be allowable long before the actual expenditure is paid. For example, consider the situation of a strip-mining company which must, under applicable law, reclaim land when its operations conclude.[32] Although the actual reclamation of the land may not occur for many years, courts have decided that once mining operations have begun, liability for the expense of future reclamation may be sufficiently fixed to satisfy the first prong of the all events test.[33] Thus, strip-mine operators may be allowed to deduct the costs of reclamation in the year in which the land is mined. Because the present value of future reclamation costs is often far less than the amount deducted, the taxpayer realizes a windfall.[34]

The courts have often followed this lenient interpretation of the liability prong of the all events test in the years leading up to the *General Dynamics* decision.[35] Although the courts have disallowed a deduction when the time lapse between accrual and payout has been extremely large,[36] usually those decisions have been based on some other aspect of the tax law besides the all events test.[37] In fact, the Supreme Court has recently reaffirmed the position that the mere possibility that a taxpayer may go out of business in the interim period, and thus never actually pay out the deducted amount, is not a sufficient enough contingency to defeat the taxpayer's deduction.[38] Such an interpretation of the all events test has long concerned congressional members intent on providing for the public treasury. A major attempt to deal with this problem, and to prevent the windfalls[39] that accrual method taxpayers were realizing, came with the 1984 Act's amendments to the Code.[40] Those amendments added a new "economic performance" requirement to the all events test.[41]

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32. This example is based on the facts of Ohio River Collieries Co. v. Commissioner, 77 T.C. 1369 (1981). For a more complete discussion of this example and related cases, see Jensen, *The Deduction of Future Liabilities by Accrual-Basis Taxpayers: Premature Accruals, The All Events Test, and Economic Performance*, 37 U. FLA. L. REV. 443, 455–61 (1985).

33. *See, e.g.*, Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951); Denise Coal Co. v. Commissioner, 271 F.2d 930 (3d Cir. 1959); Ohio River Collieries Co. v. Commissioner, 77 T.C. 1369 (1981). In each of these cases, the taxpayer was under a statutory obligation to post a surety bond in order to ensure future performance. However, this does not change the fact that deductions were allowed for costs that would not actually be incurred until a future taxable year.

34. For an illustration of how this early deduction provides a windfall, see Note, *supra* note 1.

35. *See, e.g.*, United States v. Hughes Properties, Inc., 476 U.S. 593 (1986) (discussed in depth in Part VI of this Comment).

36. *See, e.g.*, Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969). Mooney, Inc. was a manufacturer of executive aircraft that issued, with each aircraft sale, a bond that could be redeemed for $1000 when the aircraft was retired from service. The court denied Mooney the deduction for the cost of redeeming such bonds in the year of issuance stating that the time lapse involved was too great.

37. For example, in *Mooney* the court decided that allowing the deduction would not "clearly reflect income," thus violating I.R.C. § 446(b) (1982). In fact, the court did find that the liability prong of the all events test had been met. *Mooney*, 420 F.2d at 405–06.

38. *Hughes Properties*, 476 U.S. at 605–06.

39. It should be noted that accrual method taxpayers often must include income in a taxable year prior to when such payment is actually received. Thus, it is at least arguable that acceleration of deductions is not a windfall at all but merely offsets losses due to the inclusion of income that has not yet been received. However, the legislative history of the 1984 Act does not disclose any discussion of this theory. Congress was only concerned that allowing premature deductions contributes to revenue loss and the creation of tax shelters. H.R. REP. No. 432, 98th Cong., 2d Sess. 1254, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 915–16 [hereinafter HOUSE REPORT].

40. *See* 1984 Act, *supra* note 2.

41. *Id.*

IV. Section 461(h) and the Economic Performance Requirement

Though the time value of money problem had existed in the all events test for many years, it was not until the 1984 Act that Congress addressed the problem directly. The legislative history of the 1984 Act indicates that Congress was "concerned about the potential revenue loss from . . . overstated deductions . . . [due to the allowance of] deductions currently for an amount to be paid in the future."[42]

Congress had two alternatives to choose from in order to provide a solution to the loss of revenue problem. First, a deduction could be allowed for only the discounted present value of a future obligation. While serious consideration was given to this alternative, Congress eventually decided that such a system would be "extraordinarily complex and . . . extremely difficult to administer."[43]

The second alternative resulted in the adoption of section 461(h) in the 1984 Act.[44] Section 461(h) provides that "in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs."[45] Generally, economic performance will occur at the same time or after the all events test is met. However, in certain situations, ecomonic performance may occur before the all events test is met.[46]

Although section 461(h) specifies when economic performance is met in several situations,[47] the determination of when economic performance has occurred will usually be made by applying one of three general tests provided in that section. [48]

First, if the liability of the taxpayer arises out of "services [provided] to the taxpayer by another person, economic performance occurs as such person provides such services."[49] Thus, for example, if a taxpayer hires a contractor to reclaim strip-mined land, the deduction for the expenditure cannot be taken until the taxable year in which the reclamation services are performed.[50]

Second, if the liability of the taxpayer arises out of "the providing of property to the taxpayer by another person, economic performance occurs as the person provides such property."[51] Thus, if a taxpayer orders a shipment of pencils from a supplier, the taxpayer may not deduct the cost of the pencils until the taxable year in which the pencils are delivered.

Finally, if the liability of the taxpayer arises out of "the use of property by the

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42. *See* House Report, *supra* note 39, at 1254.

43. *Id.* For an argument that this alternative should be adopted, see Note, *supra* note 1, at 202–09.

44. *See supra* note 7.

45. I.R.C. § 461(h)(1) (Supp. IV 1986).

46. Several commentators argue that the fact pattern in *General Dynamics* is one such situation. *See infra* notes 129–34 and accompanying text.

47. For example, I.R.C. § 461(h)(2)(C) (Supp. IV 1986) states that in the case of tort claims and workers compensation liabilities, economic performance does not occur until payment is actually made.

48. I.R.C. § 461(h)(2)(A) (Supp. IV 1986).

49. I.R.C. § 461(h)(2)(A)(i) (Supp. IV 1986).

50. The legislative history of the 1984 Act specifically deals with this situation, thus changing the result of the strip-mining cases discussed in Part III of this Comment. House Report, *supra* note 39, at 1255. This section of the legislative history also states that, if the strip-mining company itself reclaims the land, economic performance occurs when the land is reclaimed.

51. I.R.C. § 461(h)(2)(A)(ii) (Supp. IV 1986).

taxpayer, economic performance occurs as the taxpayer uses such property."[52] Thus, if the taxpayer enters into the lease of a building that does not begin until some future date, rental payments can be deducted only as they apply to the actual use of the building.

It is easy to see that many situations will arise that do not fit neatly into any one of these three categories.[53] Although the Code also provides for the promulgation of regulations by the Treasury Department to interpret economic performance,[54] no permanent regulations have yet been issued.[55] In addition, because section 461(h) did not take effect until July 18, 1984, there is no significant judicial precedent interpreting its provisions.[56] Thus, although section 461(h) did not actually apply to the *General Dynamics* decision because the case arose before July 18, 1984,[57] the brief consideration that the Court gave to section 461(h) in *General Dynamics* may have a profound effect on the application of that section in the future.[58]

V. *United States v. General Dynamics Corp.*

In April 1987 the Supreme Court decided the case of *United States v. General Dynamics Corp.*,[59] adding what many consider to be further confusion to what was already a controversial area of federal tax law. The factual situation in *General Dynamics* arose prior to 1984 so the all events test was applied without its newly added requirement of economic performance.[60] However, the disposition of *General Dynamics*, when considered in the context of other Supreme Court decisions,[61] sheds some light on how both the all events test and the ecomonic performance requirement will be interpreted in the future.[62]

A. *Facts*

General Dynamics involved the attempt of an accrual method taxpayer to deduct estimated liabilities for employer health care costs.[63] Prior to 1972, General Dynamics had purchased medical coverage for its employees from several group health insurance carriers.[64] In 1972, General Dynamics became self-insured with

52. I.R.C. § 461(h)(2)(A)(iii) (Supp. IV 1986).

53. One such situation constitutes the fact pattern of the *General Dynamics* case. *See infra* notes 63–78 and accompanying text.

54. I.R.C. § 461(h)(2) (Supp. IV 1986).

55. The Commissioner has, however, issued two temporary regulations dealing with section 461(h). Temp. Treas. Reg. § 1.461-3T (1987) deals with the effective date of the section. Temp. Treas. Reg. § 1.461-4T (1987) deals with the relationship between economic performance and certain employee benefit plans. It has been suggested that section 461(h) is not self-enforcing without interpretive regulations. *See* Sheppard, *Economic Nonperformance: Doing Without Section 461(h) Regulations*, 40 TAX NOTES 337, 338 (1988).

56. There have, however, been a few IRS rulings interpreting section 461(h). *See, e.g.*, Priv. Ltr. Rul. 86-23-021 (Mar. 7, 1986); Priv. Ltr. Rul. 86-08-004 (Nov. 5, 1985); Priv. Ltr. Rul. 86-01-012 (Sept. 30, 1985); Priv. Ltr. Rul. 85-09-110 (Dec. 10, 1984).

57. United States v. General Dynamics Corp., 481 U.S. 239, 243 n.3 (1987).

58. *See infra* notes 129–37 and accompanying text.

59. 481 U.S. 239 (1987).

60. *Id.* at 243–44.

61. *See infra* notes 116–24 and accompanying text.

62. *See infra* notes 125–37 and accompanying text.

63. *General Dynamics*, 481 U.S. at 241.

64. *Id.*

regard to medical benefits.[65] Thus, it would pay all approved employee health care claims out of its own funds. General Dynamics did, however, retain the services of private carriers to administer its health care plan.[66]

Under its new plan, employees submitted claim forms in order to obtain reimbursement for medical services rendered by their doctors.[67] After a claim form was submitted, it was reviewed by benefits personnel to ensure that the particular employee involved was eligible under the plan.[68] The forms were then reviewed by the plan administrators, who approved payment of those expenses that were covered under the plan.[69]

General Dynamics was entitled, without question, to deduct the cost of approved medical expenses as "ordinary and necessary expenses" incurred in carrying on a business.[70] The conflict arose when General Dynamics attempted to deduct estimated costs for medical services which had been rendered to its employees *during* the taxable year, but for which claim forms had not been submitted by the employee *before* the close of the taxable year.[71] Such unclaimed costs were common because of the time lag between the actual receipt of the medical care by an employee and his or her subsequent submission of a claim form to the benefits personnel. A further time lag existed between the time the claim form was submitted and the time the expense was approved and paid.[72]

General Dynamics estimated the amount of its "unclaimed" services with the help of its previous private insurance carriers, and the reasonableness of these estimates was never a major issue in the case.[73] The IRS, however, disallowed the deduction, claiming that the liability for the medical expenses did not become fixed for purposes of meeting the first prong of the all events test until an employee had actually submitted a health care claim form and the claim had been approved for payment.[74]

General Dynamics sought review in the United States Claims Court,[75] which allowed the deduction, holding that the all events test had been met when the services were rendered to the employee.[76] The Court of Appeals for the Federal Circuit

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65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. I.R.C. § 162(a) (1982).

71. *General Dynamics*, 481 U.S. at 241–42. Actually, General Dynamics did not attempt this deduction until after the IRS began an audit of its 1972 tax return in 1977. General Dynamics then filed an amended return with those deductions listed.

72. *Id.* at 241.

73. *Id.* at 242 n.2. Thus, the "reasonable accuracy" prong of the all events test was not an issue in the case. It has been suggested, however, that the reasonable accuracy prong should have been the primary focus of the Court in *General Dynamics*. *See* Sheppard, *Economic Nonperformance: Doing Without Section 461(h) Regulations*, 40 TAX NOTES 337, 340 (1988).

74. *General Dynamics*, 481 U.S. at 242.

75. General Dynamics Corp. v. United States, 6 Cl. Ct. 250 (1984).

76. "We find that the last event necessary to fix plaintiff's liability was the *occurrence* of the insured event. . . . Applying the 'all-events' test to the facts of this case in a reasonable and practical manner demonstrates that plaintiffs satisfy the first prong of the test." *Id.* at 255 (emphasis in original) (footnote omitted).

affirmed the claims court decision[77] and the Supreme Court granted certiorari in 1986.[78]

B. *Holding*

The Supreme Court began its *General Dynamics* opinion with a discussion of the two-part all events test.[79] The Court relied heavily on its earlier decision in *Brown v. Helvering*.[80] *Brown* involved an insurance agent's taxable commissions on the sale of fire insurance policies. If a policy were later cancelled by the holder, the agent would be liable to return a portion of the commission to the company.[81] The agent attempted currently to deduct the amount of returned commissions that he estimated would be required in future years.[82] The Court in *Brown* disallowed the deduction, despite the accuracy of the estimate, because it was based on events (*i.e.* the policy cancellations) that would not occur until future taxable years.[83]

The Court in *General Dynamics* concluded that the health care deductions, like the commission refund in *Brown*, were based on a future event—the filing of a health care claim form.[84] The Court refused to accept the company's argument that the filing was "a mere technicality,"[85] pointing out that the chance that a claim form would never be filed by an employee represented more than an "extremely remote and speculative possibility."[86] The Court did recognize, however, that once covered services were rendered, the company could not escape its payment obligation by discharging the employee.[87] In fact, the only way that the company could avoid the obligation once a valid claim had been submitted would be to declare bankruptcy.[88] Nonetheless, the Court refused to accept the company's proposition that the liability for all events test purposes was fixed upon the rendering of medical services and therefore disallowed the deductions.[89]

The Court did acknowledge that the all events test would be met when a claim form was filed.[90] Thus, the Court accepted the fact that subsequent processing of the claim form was " 'routine, clerical', and 'ministerial in nature' "[91] and not required before a deduction would be allowed.

Finally, the Court bolstered its holding by pointing out that qualified private insurance companies are specifically permitted by the Code to deduct costs of claims

77. General Dynamics Corp. v. United States, 773 F.2d 1224 (Fed. Cir. 1985).
78. 476 U.S. 1181 (1986).
79. United States v. General Dynamics Corp., 481 U.S. 239, 242–43 (1987).
80. 291 U.S. 193 (1934).
81. *Id.* at 196.
82. *Id.* at 197–98.
83. *Id.* at 198–203.
84. *General Dynamics*, 481 U.S. at 244.
85. *Id.*
86. *Id.* (quoting United States v. Hughes Properties, Inc., 476 U.S. 593, 601 (1986)).
87. *General Dynamics*, 481 U.S. at 244 n.5.
88. Such a possibility was not believed to be sufficient to defeat the all-events test in *Hughes Properties*. *See infra* notes 105–15 and accompanying text.
89. *General Dynamics*, 481 U.S. at 244.
90. *Id.*
91. *Id.* at n.4 (quoting the claims court decision).

that are actuarially likely, but not yet reported.[92] The Court reasoned that if the all events test itself permitted such deductions, this section of the Code would be redundant and unnecessary. The Court was not willing to adopt such a construction.[93]

C. *Analysis of the Holding*

The Court's decision in *General Dynamics* is flawed in many respects. First, the Court places a heavy emphasis on its earlier decision in *Brown v. Helvering*.[94] However, the facts in *Brown* are quite different from the facts in *General Dynamics*. While estimates of future liabilities were involved in both cases, *Brown* involved an estimate of how many policies would *later* be cancelled.[95] *General Dynamics*, however, involved an estimate of how many services had *already been* rendered.[96] The *Brown* facts are more analogous to a deduction by General Dynamics for medical services that it estimated would be rendered in future taxable years, a deduction that was not attempted.[97] Even though there did exist a chance that some claims may never be filed, this possibility could be, and probably was, accounted for in General Dynamics' estimating procedure.[98]

Second, it is inconsistent that the Court was willing to accept the claims court's finding that the claim processing procedure was ministerial and routine, while at the same time stating that the claims court "did not . . . make any factual findings with respect to the *filing* of claims."[99] In fact, the claims court opinion contained the following language:

> In the instant case, the events of *claim filing* and processing similarly are ministerial in nature. As a result, they are not a condition precedent to establishing the fact of liability.[100]

Despite this language, the Court concluded that while processing of a claim form was ministerial in nature, the actual filing of the form was not. Such reasoning seems flawed because the chance that a claim will be denied during the processing stage is probably greater than the chance that a claim form will never be filed at all. But the language of the Court would suggest that a deduction would initially be allowed in the former instance, but not in the latter.[101]

The Court's argument that qualified insurance companies are specifically

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92. *Id.* 481 U.S. at 246–47. (referring to 26 U.S.C. § 832(b)(5)). General Dynamics had never sought to be treated like an insurance company. *Id.* 481 U.S. at 247 n.7.

93. *Id.* at 246–47.

94. *See supra* notes 79–84 and accompanying text.

95. *See supra* notes 81–83 and accompanying text.

96. *See supra* notes 63–78 and accompanying text.

97. *See* Jefferies, *The Supreme Court's General Dynamics Decision is Bad Law*, 36 TAX NOTES 525, 526 (1987) [hereinafter Jefferies] ("[*Brown*] is so clearly inapplicable to the *General Dynamics* situation, that one must wonder whether the Court recognized the difference between the cash and the accrual methods of accounting.").

98. *See id.*

99. *General Dynamics*, 481 U.S. at 244 n.4. (emphasis in original).

100. General Dynamics Corp. v. United States, 6 Cl. Ct. 250, 254 (1984) (emphasis supplied).

101. "Here, respondent made no showing that, as of December 31, 1972, it knew of specific claims which had been filed but which it had not yet processed." *General Dynamics*, 481 U.S. at 245. Apparently, the Court would have allowed a deduction for such unprocessed claims, even though they might later be found invalid. The claims court decision points out that approximately 90% of all submitted claims are paid. *General Dynamics*, 6 Cl. Ct. at 254. It is unclear whether the Supreme Court would have required this percentage to be used for any claims submitted, though not yet processed.

permitted to deduct costs of some unreported claims is perhaps the strongest argument made.[102] However, the majority used this rationale mainly to bolster its other arguments[103] and it is not clear that the Court would have found this negative inference sufficiently persuasive if standing alone.

However, the principal flaw in the Court's opinion, and the portion of the decision that has contributed the most to the confusion in the application of the all events test, is the treatment given to the 1986 Supreme Court decision in *United States v. Hughes Properties, Inc.*[104]

VI. *United States v. Hughes Properties, Inc.*

For the Court to reach its decision in *General Dynamics*, it first had to contend with its own decision issued one year earlier in *United States v. Hughes Properties, Inc.*. The Court's distinction of that case, along with a comparison of the two cases themselves, provides some insight into how the Court will treat questions in this area of tax law in the future.[105]

A. *Facts*

Hughes Properties involved the deduction by a Nevada casino of progressive slot machine jackpot amounts.[106] With a progressive slot machine, the jackpot amount increases as money is gambled in the machine. Depending on the odds set by the casino for each machine, the jackpot may be awarded soon after the machine is initially funded, or the time lag may be quite long, often covering more than one taxable year.[107] The longer the time lag, the larger the eventual winning jackpot will be. The casino attempted to deduct the amount that the jackpot had reached by June 30 (the conclusion of its fiscal year), on the theory that it would eventually be liable for at least that amount.[108] Under applicable state law, the only way the casino could escape that obligation would be to cease its operations, probably through bankruptcy.[109]

The Court in *Hughes Properties* allowed the deduction, stating that liability "was not contingent upon the time of payment or the identity of the jackpot winner."[110] The Court held that state law fixed the liability of the taxpayer in this case[111] and that "existence of an absolute liability is necessary; absolute certainty that it will be discharged by payment is not."[112] The Court recognized that the casino

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102. *See supra* notes 92–93 and accompanying text. In fact, General Dynamics responded rather weakly to this argument in its brief to the Supreme Court, merely stating that it had never claimed to be an insurance company and noting that there were no cases directly on point. Brief for General Dynamics at 42–43, United States v. General Dynamics Corp., 481 U.S. 239 (1987) (No. 85-1385).

103. *General Dynamics*, 481 U.S. at 246–47.

104. 476 U.S. 593 (1986).

105. *See infra* notes 125–37 and accompanying text.

106. *Hughes Properties*, 476 U.S. at 595–97.

107. The average time for payoff at Respondent's casino had been 4 1/2 months. *Id.* at 596 n.1.

108. *Id.* at 597.

109. *Id.* at 596 (referring to § 5.110 of the Nevada Gaming Regulations).

110. *Id.* at 601.

111. *Id.* at 601 (referring to § 5.110.2 of the Nevada Gaming Regulations).

112. *Id.* at 606 (quoting Helvering v. Russian Fin. & Constr. Corp., 77 F.2d 324, 327 (2d Cir. 1935)).

could potentially avoid its obligation by declaring bankruptcy, surrendering its license, or otherwise going out of business, but felt that such situations represented an "extremely remote and speculative possibility."[113] Since no other contingency existed, the Court decided that the all events test had been met.[114] Because, as in *General Dynamics*, the factual situation in *Hughes Properties* arose before the effective date of section 461(h), the economic performance doctrine did not apply.[115]

B. *A Comparison of* General Dynamics *and* Hughes Properties

The Court in *General Dynamics* distinguished the *Hughes Properties* decision by stating that the filing of a health care claim form did not represent the "extremely remote and speculative possibility" recognized in *Hughes Properties*.[116] A vigorous dissent in *General Dynamics* suggested that the "circumstances of [*General Dynamics*] differ little from those in *Hughes Properties*."[117] The dissent pointed out that the mere fact that an individual entitled to a payment later decides to waive that payment does not render the initial liability of the payor any less fixed.[118] In the opinion of the dissenters, the failure of an employee to file a claim form represented nothing more than such a waiver.

While there is certainly an argument that *General Dynamics* cannot be distinguished from *Hughes Propreties*, there is also an argument that the dispositions of both cases should, if anything, be reversed. First, the time lag in *Hughes Properties* could potentially be much longer than that in *General Dynamics*. While health care claim forms would presumably be filed very shortly after the beginning of new taxable year, a winning slot machine jackpot could conceivably be delayed many years.[119] Courts have previously disallowed deductions in similar situations because the time lag between the fixing of liability and actual payment is excessive.[120] This reasoning is also supported by Congress' recent adoption of the requirement of economic performance.[121]

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113. *Id.* at 601. It is interesting that the Court provides a footnote with this quotation explaining that "all the progressive machine jackpots unpaid as of June 30, 1977, 'were subsequently won and paid to customers.'" *Id.* at 602 n.3 (quoting the affidavit of the president of Hughes Properties' Harolds Club Division). The Court seems to suggest that hindsight may play a role in determining if a possibility is extremely remote.

114. *Id.* at 606.

115. The Court did, however, make brief, though inconclusive, mention of section 461(h) in a footnote. *Id.* at 604 n.4. *See also infra* note 129.

116. United States v. General Dynamics Corp., 481 U.S. 239, 244–45 (1987).

117. *Id.* at 248 (O'Connor, J., dissenting).

118. *Id.* at 249 (O'Connor, J., dissenting).

119. *See supra* notes 107–08 and accompanying text.

120. *See supra* notes 36–37 and accompanying text.

121. I.R.C. § 461(h)(3) (Supp. IV 1986) provides an exception to the requirement of economic performance for certain recurring items. Subsection (A) provides that such items will be considered to be incurred in the taxable year despite the lack of economic performance if:

> (i) the all events test with respect to such item is met during such taxable year (determined without regard to paragraph(1)),
>
> (ii) economic performance with respect to such item occurs within the shorter of—
>
> (I) a reasonable period after the close of such taxable year, or
>
> (II) 8 1/2 months after the close of such taxable year,
>
> (iii) such item is recurring in nature and the taxpayer consistently treats items of such kind as incurred in the taxable year in which the requirements of clause (i) are met, and

Second, the taxpayer in *Hughes Properties* actually had some control over just how long this time lag would be. By setting higher odds on a particular machine, deferral of payment would be longer.[122] As indicated earlier, a long deferral is almost always to the taxpayer's advantage.[123]

Finally, as the dissent in *Hughes Properties* points out, if bankruptcy were declared by a casino before the jackpot was awarded, there would not be an obligation that could be discharged in a bankruptcy proceeding.[124] Because there has not yet been a winner, there would exist no identifiable person to claim any assets of the casino. In *General Dynamics*, however, persons with claims against the assets of the company would already exist if a petition in bankruptcy was filed between the time medical services were rendered and the time a claim form was filed. Though the company might not know the identity of these individuals, they would soon surface in order to make their claim to whatever company assets they might reach.

VII. The Future Impact of *General Dynamics*

General Dynamics and *Hughes Properties* are now a part of Supreme Court tax jurisprudence and it is difficult to say when the Court will venture into the area of accrual method tax deductions again. This Comment will now examine the changes that have occurred in the interpretation of the all events test and will also consider the effect that the *General Dynamics* decision will have upon the application of the recently adopted requirement of economic performance.

A. *The All Events Test*

Though the adoption of section 461(h) will have a major impact on the future application of the all events test, the test will retain meaning independent of section 461(h) in several situations.

One situation will occur when a case has arisen before July 1984, so that section 461(h) does not apply.[125] Though the Code's statute of limitations for filing amended returns will make the inapplicability of section 461(h) increasingly less likely, this situation may still arise.[126]

(iv) either—

(I) such item is not a material item, or

(II) the accrual of such item in the taxable year in which the requirements of clause (i) are met results in a more proper match against income than accruing such item in the taxable year in which economic performance occurs.

It is likely that all of the deductions in *General Dynamics* would meet the 8 1/2 month requirement. However, it is quite possible that many of the deductions in *Hughes Properties* would not.

122. However, as the Court pointed out, if unreasonably high odds are set, customers may refuse to play the machines. *Hughes Properties*, 476 U.S. at 605.

123. *See supra* note 1 and accompanying text.

124. *Hughes Properties*, 476 U.S. at 608 (Stevens, J., dissenting). Justice Stevens felt that the key distinction was between the "*nonpayment* of a legal obligation and the *nonexistence* of an obligation. . . ." *Id.* (Stevens, J., dissenting) (emphasis in original).

125. Recall that *General Dynamics* itself was such a case. *See supra* note 60 and accompanying text.

126. For a discussion of statutes of limitation in the Internal Revenue Code, see B. Bittker, Fundamentals of Federal Income Taxation § 41 (1983).

Another situation will occur when the economic performance requirement is met *before* all of the other requirements of the all events test are met. Some commentators have suggested that a fact situation such as that of *General Dynamics* would be one example.[127] This possibility will be explored below.

Regardless of the reason for the continuing importance of the all events test, it is clear that the *General Dynamics* decision will be closely examined whenever an analogous situation arises. The opinion can be read to suggest that the Court itself has become concerned about the time value of money. In this sense, the opinion may well be read to have grafted its own judicial requirement of economic performance onto the judicially created all events test. Though the Court in *General Dynamics* did distinguish *Hughes Properties*,[128] under this analysis it must be asked whether *Hughes Properties* continues to be a useful precedent for purposes of interpreting the liability prong of the all events test. At a minimum, *General Dynamics* suggests that contingencies of any sort, with the possible exception of a discharge in bankruptcy, will be examined with a very critical eye whenever a taxpayer is claiming an accrual method deduction for a future liability.

B. *The Impact on Section 461(h)*

An argument can be made that the decision in *General Dynamics* has been rendered moot by the enactment of section 461(h). If economic performance does not occur until the filing of a claim, *General Dynamics* has no continuing precedential effect, at least in identical factual situations.[129] But some commentators have taken the position that economic performance is met when medical services are rendered,[130] thus creating a situation when economic performance occurs before the other requirements of the all events test are satisfied. There is, however, no clear-cut category in section 461(h) into which the facts of *General Dynamics* fall.[131]

The case arguably does not involve the provision of services to the taxpayer because services are actually provided to the employee. Though, as a self-insurer, General Dynamics paid for the medical services, it is unclear that this arrangement falls within the first interpretive provision of section 461(h).[132] The second[133] and third[134] interpretive provisions clearly do not apply.

Though the facts in *General Dynamics* arose before the effective date of section 461(h), the opinion does make reference to the economic performance doctrine. In a footnote, the Court states:

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127. *See infra* note 130 and accompanying text.

128. *See supra* notes 116–17 and accompanying text.

129. *See* Jensen, *Hughes Properties and General Dynamics: The Supreme Court, the All Events Test, and the 1984 Tax Act*, 32 TAX NOTES 911, 917–18 (1986). Professor Jensen suggests that *Hughes Properties* is probably a case that has been rendered moot by the enactment of section 461(h). He does say, however, that *Hughes Properties* continues to have effect in cases where economic performance precedes the occurrence of the other requirements of the all events test.

130. *See id.* at 920; *see also* Jefferies, *supra* note 97, at 526.

131. *See supra* note 48 and accompanying text.

132. *See supra* note 49 and accompanying text.

133. *See supra* note 51 and accompanying text.

134. *See supra* note 52 and accompanying text.

> We do not address how this case would be decided under section 461(h) but note that the legislative history of the Act indicates that, "[i]n the case of . . . employee benefit liabilities, which require a payment by the taxpayer to another person, economic performance occurs as the payments to such person are made."[135]

This language suggests that, in the future, a deduction will not be allowed until actual payment is made to the renderer of medical services or reimbursement is made to the employee. Such an interpretation essentially requires a self-insurer to use a cash method system of tax accounting for purposes of employee benefits. The portion of the legislative history which the Court quotes speaks also of tort and workers compensation benefits.[136] Both of those types of expenses are specifically addressed in section 461(h) and for both, a deduction is prohibited before payment is made.[137] Though only time will tell how much deference is paid to this passing reference by the Court, it would seem to be a useful tool for the IRS to use in order to reduce, as much as possible, the windfall that a taxpayer realizes when a tax deduction is taken for an expenditure that will not actually be paid out until some time in the future.

VIII. CONCLUSION

Accounting for the time value of money is a problem that affects many areas of the Internal Revenue Code. Congress has been especially concerned with the prevention of what it perceives are windfalls from the accrual of deductions for estimated future liabilities. The recent addition of an economic performance requirement to the all events test will help to reduce such windfalls. However, it is clear that there will be many situations that do not fit neatly into any of the provisions of the economic performance requirement. Moreover, in many other cases, the economic performance requirement will not be controlling, and the all events test will continue to be the decisive factor in determining whether a deduction by an accrual method taxpayer is proper. How much the Supreme Court's decision in *United States v. General Dynamics Corp.* will help in resolving these problems remains to be seen.[138]

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135. United States v. General Dynamics Corp., 481 U.S. 239, 243 n.3 (1987) (quoting H.R. REP. No. 98-432 pt. II, 98th Cong., 2d Sess. 1255, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 697, 918).

136. *Id.*

137. I.R.C. § 461(h)(2)(C) (Supp. IV 1986). It is unclear why this section does not also include employee benefit liabilities as the legislative history suggests it should. For a discussion of this and other aspects of the Court's footnote, see Jensen, *The Supreme Court's Misleading Footnote in* General Dynamics, 41 TAX NOTES 665 (1988).

138. The *General Dynamics* decision was followed in a recent Ninth Circuit decision interpreting the liability prong of the all events test. In Challenge Public., Inc. v. Commissioner, 845 F.2d 1541 (9th Cir. 1988), the court held that the test was not met, in a situation where a taxpayer magazine publisher was liable to reimburse its distributors for unsold magazine copies, until the distributors provided documentation to the taxpayer of the actual amount of unsold copies, as required by contract. *See also* Cooper Comm., Inc. v. United States, 678 F. Supp. 1408 (W.D. Ark. 1987) (court cites, but does not specifically discuss, *General Dynamics* in a case involving the interpretation of the liability prong in the context of a land salesman's sales commissions); Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26 (1988) (Interpreting the liability prong in the context of inclusion in income, rather than deduction from income, the court stated that the "all events test is based on the existence or nonexistence of legal rights or obligations, at the close of a particular accounting period, not on the probability—or even absolute certainty—that such right or obligation will arise at some point in the future.").

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